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THE AMAZING THREE-HEADED LIMITED PARTNER: REFLECTIONS ON OLD LOOPHOLES AND NEW JURISPRUDENCE

Lisa Philipps*

I. INTRODUCTION

The decision of the British Columbia Court of Appeal in *Nordile Holdings Ltd. v. Breckenridge*¹ breaks new ground in the law of limited partnerships in Canada. It suggests that a limited partner who doubles as a director or officer of a corporate general partner, or who otherwise “takes part in the management”² of the partnership business, may nevertheless retain her limited liability status.

Although the court purported to follow the watershed case of *Haughton Graphic Ltd. v. Zivot*,³ a closer look reveals a radical departure from that decision. According to the judges in *Nordile*, limited partnership investors can, with some careful planning, maintain three different legal personalities concurrently. The case effectively allows a limited partner to act simultaneously as (i) a corporate executive with full managerial powers, (ii) a limited liability investor in relation to third-party creditors, and (iii) a business proprietor for income tax purposes. Contrary to previous indications in the *Haughton Graphic* case, it appears that the three-headed limited partner is alive and well and living in B.C.

For those who deal with limited partnerships, *Nordile* injects a new element of uncertainty into the question of limited-partner liability, particularly since the case is not being appealed to the Supreme Court of Canada. This article will analyze and contrast *Nordile* with the earlier, precedent-setting decision in *Haughton*

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¹ (1992), 66 B.C.L.R. (2d) 183 (C.A.), affg [1991] B.C.W.L.D. 860 (S.C.).

² Partnership Act, R.S.B.C. 1979, c. 312, as amended, s. 64.

³ (1986), 33 B.L.R. 125 (Ont. H.C.J.), affd 38 B.L.R. xxxiii (Ont. C.A.), leave to appeal refused 38 B.L.R. xxxiii (S.C.C.).

Graphic at a number of levels. It will be argued first that the two cases give conflicting statements of legal doctrine, and that the *Nordile* decision is therefore likely to destabilize existing legal and commercial practices.

In the second part of the article it will be argued that this doctrinal conflict is rooted in the differing political and moral attitudes which informed each court's interpretation of the limited-partnership legislation. Juxtaposed with one another, these decisions illustrate the importance of judicial values and assumptions in statutory construction.

Finally, the *Nordile* decision provides an opportunity to reconsider whether limited partners, whose rights and obligations look increasingly like those of corporate shareholders, should continue to be treated as partners for income tax purposes. It will be argued in the third part of the article that the tax preferences now available to limited partners should be curtailed.

II. LIMITED PARTNER LIABILITY: DOCTRINAL TENSIONS

1. Overview of the Legal Issues

The litigation in *Haughton Graphic* and *Nordile* revolved around the interpretation of two analogous provisions in the B.C. and Alberta limited partnership statutes. Section 64 of the B.C. Partnership Act⁴ states:

64. A limited partner is not liable as a general partner unless he takes part in the management of the business.

The provision in the Alberta Partnership Act is similar, but instead of "management" it uses the term "control".⁵ Virtually identical provisions exist in most of the common law provinces and the territories.⁶ They reflect the unique combination of traditional

⁴ *Supra*, footnote 2.

⁵ R.S.A. 1980, c. P-2, as amended, s. 63. There are some other differences between the Alberta and B.C. provisions as well. The Alberta section provides that "[a] limited partner does not become liable as a general partner unless, in addition to exercising his rights and powers as a limited partner, he takes part in the control of the business" (emphasis added). However, none of the judges in either case commented upon these additional words in the Alberta statute, or their absence in the B.C. provision.

⁶ Most jurisdictions use the term "control": see, for example, the Limited Partnerships Act, R.S.O. 1990, c. L.16, s. 13(1); the Limited Partnership Act, S.N.B. 1984, c. L-9.1, s. 17(1); the Limited Partnerships Act, R.S.N.S. 1989, c. 259, s. 17; and the Limited Partnerships Act, R.S.P.E.I. 1988, c. L-13, s. 12. Yukon appears to be the only other

partnership and limited-liability elements which characterizes the limited partnership. This hybrid business vehicle was not recognized at common law. Under the general principles of partnership law, all partners were personally liable for unpaid partnership debts, to the full extent of their assets.⁷ Attempts to limit the liability of so-called "passive" investors by contract met with mixed success in the courts.⁸

General partnerships are still governed by this principle of personal liability. However, legislation now allows for the creation of limited partnerships, which offer a virtual guarantee of limited liability subject to certain conditions.⁹ First, there must always be at least one general partner to stand behind the business to the full extent of her assets. Managerial power rests almost exclusively with this general partner or partners. The limited partners must not interfere in the management or control of the partnership business. They have the power to veto certain major decisions, but otherwise are required to remain passive. If limited partners do take part in management or control they may become liable as general partners pursuant to s. 64 of the B.C. Partnership Act or its counterparts in other provinces.

The legislative balance of powers and liabilities within the limited partnership has been undermined to some extent by allowing corporations to perform the role of general partner. If the sole general partner is a corporation with no assets, creditors are effectively in the same position as if the business was incorporated from the outset. This in itself may not be objectionable within the framework of our legal and commercial systems, in which corporations are recognized as separate legal persons for almost all purposes. However, *Nordile* and *Haughton Graphic* illustrate how promoters can manipulate this combination of corporate and partnership forms in order to avoid certain obligations which are fundamental to the limited partnership form. In particular, limited partners may attempt to use the corporation as a vehicle for indirectly managing or controlling the partnership business.

jurisdiction, besides B.C., which uses the term "management": see the Partnership Act, R.S.Y. 1986, c. 127, s. 63.

⁷ See Lyle R. Hepburn and William J. Strain, *Limited Partnerships* (Don Mills, Richard DeBoo Publishers, 1984), pp. 1-1 to 1-7; and *Lindley and Banks on Partnership*, 16th ed. (London, Sweet & Maxwell, 1990), pp. 733-5.

⁸ See *Lindley and Banks*, *ibid.*, at pp. 5-29.

⁹ These basic conditions are set out in ss. 50, 55 to 58 and 64 of the B.C. Partnership Act, *supra*, footnote 2.

By appointing themselves as directors or officers of the corporate general partner, limited partners may be able to retain their protected status but avoid the inconvenience of having to remain passive. In *Haughton Graphic*, the court refused to give effect to this legal structure, and held the limited partners personally liable for the debts of the insolvent limited partnership. In *Nordile*, however, the B.C. Court of Appeal came to the opposite conclusion, holding that the limited partners had not exposed themselves to liability despite exercising extensive powers as managers of the corporate general partner.

The *Nordile* case also adds one new twist to the issue of limited-partner liability. The court held that even if the defendants *had* taken part in management, any personal liability on their part was excluded by the terms of their contract with the plaintiff. This alternative basis for the decision suggests that it may now be possible to alter the statutory balance of powers and responsibilities within limited partnerships simply by contracting out of certain aspects of the legislative regime.

2. Facts and Issues in *Nordile*

The judgments in *Nordile* are short on detail, but documents filed by the parties provide a more complete picture of the facts and arguments presented in court. John Breckenridge and his co-defendant Hubert Rebiffe were the two subscribing limited partners of Arman Rental Properties Limited Partnership (“Arman”) when it was formed on December 31, 1980. By the time of trial, Arman had a total of 63 limited partners, including the two defendants.¹⁰ The sole general partner of Arman was a corporation — Arbutus Management Inc. (“Arbutus”) — in which each of the defendants were minority shareholders. The defendants also acted as directors and officers of Arbutus. This structure is strikingly similar, though not identical, to that considered in *Haughton Graphic*.

In 1981 the plaintiff, Nordile Holdings Ltd. (“Nordile”), sold some commercial real property to Arman, taking back a second mortgage as part of the purchase price. Arman eventually defaulted on its mortgage payments and, in 1985, the first mortgagee foreclosed its interest. By the time Nordile obtained

¹⁰ Statement of Claim, para. 6.

judgment against Arman and Arbutus for the balance owing on the second mortgage, both were insolvent. Nordile then sued Breckenridge and Rebiffe personally to recover the amount of the unsatisfied judgment. The threshold question was whether Breckenridge and Rebiffe had taken part in the "management" of Arman, thereby rendering themselves liable as general partners under s. 64 of the Partnership Act.

The exact nature of the defendants' involvement in the business is not very clear from the public record, as the parties proceeded on a fairly succinct agreed statement of facts. It appears Breckenridge was "primarily responsible for the operations of Arbutus",¹¹ and that Rebiffe also helped to manage Arbutus but "to a lesser extent".¹² The defendants were the only officers of Arbutus in 1981 when the purchase from Nordile took place, Breckenridge being the president and Rebiffe the secretary.

At the end of 1985, Rebiffe resigned his post and Breckenridge acted thereafter as the company's sole officer.¹³ The agreed facts indicate that "major management decisions such as the purchase of real property" required majority approval by the directors.¹⁴ From 1981 until August 30, 1984, the defendants constituted only a minority or, at most, 50% of the board of Arbutus. From August 30, 1984 onward, however, they comprised the majority of directors. It was during this latter period that the first mortgagee commenced foreclosure proceedings against Arman.¹⁵

Thus far the story suggests that the defendants were quite intimately involved in the affairs of Arbutus and Arman. However, the statement of facts also discloses that "day to day management decisions regarding the operations of Arman were made by a staff of property managers employed by Arbutus."¹⁶ Though no details are supplied about the identity of these employees, the clear implication is that Breckenridge and Rebiffe maintained some distance from routine managerial activities. More importantly, the agreed facts state that the defendants "participated in the management [of Arman] . . . solely in their capac-

¹¹ Para. 25 of the agreed facts, cited in the unreported reasons of Esson C.J. at trial (Vancouver Registry No. A870646, February 19, 1991).

¹² Court of Appeal judgment, *supra*, footnote 1, at p. 185.

¹³ Agreed facts, para. 13.

¹⁴ Para. 27.

¹⁵ *Ibid.*, para. 12.

¹⁶ Para. 28, cited in the unreported reasons of the trial judge, *supra*, footnote 11.

ities as directors and officers of the general partner, Arbutus' ".¹⁷ This turned out to be a major concession on Nordile's part.

There is also some confusion about the nature and extent of the defendants' involvement in the transaction with Nordile. According to the agreed facts, Nordile's sole shareholder and manager "had no direct contact with John Breckenridge and only a brief telephone conversation with Hugh Rebiffe".¹⁸ However, on appeal Nordile asserted that both defendants "participated directly in the acquisition of Nordile's property".¹⁹ Documents filed in court show that both signed the sale and purchase agreement (the "agreement") and the mortgage as authorized signatories of Arbutus, which executed the documents on behalf of Arman.²⁰

Moreover, a week before signing the agreement, Breckenridge gave Nordile a disclosure statement as required by the Real Estate Act.²¹ Section 28 of that Act prohibits any person licensed under the statute from directly or indirectly offering to acquire real estate unless she has first disclosed certain information to the owner. The disclosure must indicate, among other things, that the person is a "licensee" under the Real Estate Act, and that she is acquiring the real estate for herself or a corporation in which she is interested.

The disclosure statement provided by Breckenridge to Nordile stated in part the following:

Please be advised that I, John Breckenridge am licensed under the British Columbia Real Estate Act and that:

1. [Arman] will be offering to buy real estate . . . which is owned by you and which is described as . . .

[Arbutus] is the General Partner of the Purchaser, I am a shareholder, director and officer of [Arbutus]. Some Licensees of [Arbutus] are Limited Partners of the Purchaser.

2. [Arman] is purchasing the real estate and intends to hold the real estate as an investment for an indefinite period . . .

3. This disclosure is being made prior to the presentation of my offer to you to purchase the said real estate or interest therein.

¹⁷ Para. 29, cited in the Court of Appeal decision, *supra*, footnote 1, at p. 185.

¹⁸ Para. 23.

¹⁹ Appellant's factum in answer to Cross Appeal, p. 13.

²⁰ Rebiffe signed the agreement, identifying himself as a Director of Arbutus acting on behalf of Arman. Both defendants signed the mortgage as "Authorized Signatories" of Arbutus in trust for Arman.

²¹ R.S.B.C. 1979, c. 356, as amended.

4. The parties hereto acknowledge that [Arman] is a limited partnership formed under the laws of British Columbia. The parties hereto agree that the obligations of the Limited Partnership shall not personally be binding upon, nor shall resort hereunder be had to, the property of any of the limited partners of the Limited Partnership or assignees of their interest in the Limited Partnership as represented by Units of the Limited Partnership but shall only be binding upon and resort may only be had to the property of the Limited Partnership or the General Partner of the Limited Partnership.

Paragraph 4 was not required by the legislation, but was apparently added to the disclosure statement on the initiative of Breckenridge or his solicitor. This paragraph was also incorporated as recital F in the agreement between Nordile and Arman, dated April 7, 1981. These two documents became a focal point of argument in the case.

3. The Decisions

In the result, both the trial judge and the Court of Appeal held in favour of the defendants, unlike the *Haughton Graphic* case in which the limited partners were held personally liable. At trial Esson C.J. concluded that the defendants' involvement with the business amounted to taking part in management and ordinarily would have attracted liability under s. 64. However, he found that the section was contractually excluded from applying to the defendants in their dealings with Nordile because of the disclosure clause in recital F of the agreement.

The Court of Appeal not only dismissed Nordile's appeal, but strengthened the trial decision in favour of the defendants. Reversing the trial judge's initial finding, they held that Breckenridge and Rebiffe were protected from liability under s. 64 because they took part in managing the business only in their capacities as directors and officers of the corporate general partner, and not in their capacities as limited partners. Although this alone was sufficient to decide the case, the appeal judges also confirmed the decision at trial that s. 64 was in any event rendered inapplicable by recital F of the agreement.

The reasons for decision at both levels are brief and somewhat obscure. Despite endorsing certain aspects of the judgment in *Haughton Graphic*, the trial judge and the Court of Appeal approached the limited partnership legislation from a strikingly different perspective. At least in the circumstances of this case, they inclined towards a very narrow interpretation of s. 64,

thereby affording limited partners a great deal of leeway to engage in strategic planning to avoid personal liability. If followed, *Nordile* will shift the economic risks associated with limited partnership ventures further away from individual investors and onto the shoulders of financial creditors and other third parties. The reasoning of the trial and appeal courts is analyzed more closely below.

4. Reasons at Trial

Esson C.J. concluded without hesitation that the defendants “clearly took part in the management” of the partnership business within the “plain meaning” of s. 64. He dismissed the defendants’ argument that the B.C. provision requires a greater degree of managerial involvement than other provincial statutes, which target limited partners who take part in the control of the business.²² Indeed, he held that “[m]anagement covers a broader scope of activity than control and includes any activity covered by control.”²³ As such, the defendants were *prima facie* liable as general partners under s. 64.

This appears to be the first judicial interpretation of the term “management” in s. 64. Unfortunately, the status of Esson C.J.’s comments is somewhat uncertain after the appeal judgment. Though it affirmed the result at trial, the Court of Appeal side-stepped the issue of what kind or degree of activity will constitute “management”. The appeal judges neither questioned nor endorsed Esson C.J.’s construction, making it difficult to know what persuasive value it may have in another case.

Breckenridge and Rebiffe argued that even if they did take part in management they should be shielded from personal liability on the strength of the “specific reliance” analysis adopted in some American cases.²⁴ According to this analysis, liability does not attach unless the plaintiff creditor has actually been led to believe that the limited partner is a general partner. This was clearly not the case in *Nordile*, as the agreed facts stated that,²⁵

²² See footnotes 5 and 6.

²³ Unreported reasons of the trial judge, *supra*, footnote 11.

²⁴ The American cases are discussed by Eric Apps in, “Limited Partnerships and the ‘Control’ Prohibition: Assessing the Liability of Limited Partners” (1991), 70 Can. Bar Rev. 619; Robert D. Flannigan, “The Control Test of Investor Liability in Limited Partnerships” (1983), 21 Alta. L.R. 303; and William F. Ehrcke and Rosemarie Wertschek, “An Introduction to Limited Partnerships” (1981), 39 Advocate 387.

²⁵ Para. 22.

... Richard Manders as President ... of Nordile was not relying on Hubert Rebiffe or John Breckenridge with regard to making payments under said mortgage. Richard Manders admits that at the time of sale he was satisfied that Arbutus and Arman would have a sufficient cash flow derived from revenue generated by the rental of the Property to meet ... mortgage obligations ...

The underlying premise of the specific reliance argument is that a finding of liability would lead to a windfall if the complaining creditor never had a reasonable expectation that the limited partners would stand behind the obligations of the partnership.

This line of argument was flatly rejected in *Haughton Graphic*. In his judgment,²⁶ Eberle J. pointed out that the Alberta provision,

... does not contain any requirement of reliance. If reliance was a necessary precondition to unlimited liability for a limited partner, appropriate words should be in the statute. To conclude that the words in the section require such a condition would not, in my view, be an interpretation of the words used in the section, but would be a clear addition of a second, distinct requirement ...

... What engages the liability of the limited partner is his taking part in the control of the business.

In *Nordile*, Esson C.J. expressly followed *Haughton Graphic* on this point. In applying s. 64 it was irrelevant, in his opinion, whether the defendants' conduct did or did not lead Nordile to rely on them as general partners. On its face this finding would seem to render the disclosure statements provided to Nordile totally unhelpful to the defendants. If it was not important to determine whether Nordile relied on the defendants, then it should not matter what Nordile's managers understood about the legal structure of Arman. However, Esson C.J. did not stop here. Rather, he went on to hold that the parties had effectively contracted out of s. 64 altogether.

The question, as Esson C.J. put it, was "whether the liability of the defendants which would otherwise flow from section 64 is excluded by the terms of the contract between the plaintiff and Arman for the sale of the property".²⁷ Breckenridge and Rebiffe argued that Nordile was precluded from suing them by virtue of the disclosure statement, and by virtue of recital F in the agreement which simply repeated verbatim the final paragraph of

²⁶ *Supra*, footnote 3, at pp. 132-3.

²⁷ Page 3 of the unreported reasons at trial, *supra*, footnote 11.

the disclosure statement. Esson C.J. was reluctant to rely on the disclosure statement, perhaps because it did not purport to create any contractual relations. However, he decided that the single paragraph incorporated in the agreement could stand on its own. In his words,²⁸

... the language of recital F is clear enough in providing that Nordile could have resort only to the property of the limited partnership or the general partner and that the obligations of the limited partnership were not to be binding upon any of the limited partners. The effect of that is to contractually preclude the application of s. 64 to the limited partners.

This finding was confirmed by the Court of Appeal.

5. Reasons on Appeal

The Court of Appeal affirmed the trial decision on two separate grounds, each of which warrants consideration.

(1) Corporate Structure

First, the appeal judges held that Breckenridge and Rebiffe were insulated from personal liability by virtue of their dual roles within the legal structure of Arman. Nordile's concession, that the defendants had "participated in the management . . . [of Arman] 'solely in their capacities as directors and officers of the general partner' ", was, in their opinion, sufficient on its own to decide the case. Writing for the court, Gibbs J.A. reasoned that "[a]cting *solely* in one capacity necessarily negates acting in any other capacity."²⁹

In relying so heavily on Nordile's concession, the Court of Appeal appears to have elevated a factual statement about the formal structure of Arman to a conclusion about the legal implications of that structure. McEachern C.J.B.C. went even further, warning in a concurring judgment that it would "destroy the *Salomon* principle" to "conclude that an officer of a corporation acting solely in that capacity [could] be held personally liable in a different capacity".³⁰ The Chief Justice did leave room for a

²⁸ *Ibid.*, at p. 4.

²⁹ *Supra*, footnote 1, at p. 185.

³⁰ *Ibid.*, at p. 186. McEachern C.J.B.C. was referring to the House of Lords' decision in *Salomon v. Salomon & Co.*, [1987] A.C. 22, 66 L.J. Ch. 35, which is generally regarded as having established the principle of shareholder limited liability in the case of so-called one-person companies.

different conclusion in a case with "much more specific language and facts" showing that "the limited partner in that capacity engaged in management".³¹ None the less, his appeal to fundamental principles of corporate limited liability in this context sits in sharp contrast to the judgment in *Haughton Graphic*, with its emphasis on strict enforcement of personal liability.

In *Haughton Graphic*, Eberle J. took the view that liability will always arise under the statute when two conditions are fulfilled: "[o]ne is that the person be a limited partner and the second is that he take part in the control of the business."³² Indeed he implied strongly that the section would *inevitably* catch any person who, "in addition to being an officer . . . of the corporate general partner, seeks also to take advantage of personal limited liability as a limited partner in the limited partnership".³³ This is a fairer, more appropriate interpretation of the statute, particularly if the courts are not prepared to inquire into creditor reliance. It preserves in substance the balance of powers and responsibilities between general and limited partners, which is the structural foundation of the limited-partnership form. Eberle J.'s approach thus offers some degree of protection to third parties from managerial interference by limited partners.

The decision of the B.C. Court of Appeal, on the other hand, significantly undermines the statutory division of risk and responsibility in limited partnerships, and erodes the interests of third parties. If limited partners can avoid personal liability simply by taking on another organizational identity as corporate managers, then s. 64 is effectively rendered toothless. Many more business owners and investors can now be expected to exploit the income tax advantages of direct ownership while retaining the limited liability and managerial power of a corporate shareholder-director.

Moreover, the formalistic division of roles underlying *Nordile* simply does not jibe with the social realities of the marketplace. Although Breckenridge and Rebiffe may have taken on several legal identities within Arman, these roles were inevitably blurred in their dealings with third parties. Breckenridge's disclosure statement offers a telling illustration of this ambiguity. The

³¹ *Ibid.*

³² *Supra*, footnote 3, at p. 134.

³³ *Ibid.*

statement begins by disclosing that Arman intends to make an offer to buy Nordile's property but, a paragraph later, refers to "my offer [*i.e.*, Breckenridge's offer] . . . to purchase the said real estate". This inconsistency in wording may have been a minor clerical slip, but it clearly demonstrates the potential confusion that follows a segregation of limited-partner status from a management role.

There were several other, more substantive grounds upon which the court might have distinguished *Haughton Graphic*. For example, it was obvious in *Haughton Graphic* that the general partner had been incorporated by the defendants solely for the purposes of the limited partnership.³⁴ In contrast, Arbutus was formed several years before Arman, and was apparently engaged in other business activities besides acting as general partner.³⁵

In addition, Breckenridge and Rebiffe were only minority shareholders in Arbutus, and for at least part of the relevant period they did not exercise legal control over its board of directors. In *Haughton Graphic*, the main defendant was the controlling shareholder of the general partner. Perhaps more importantly, the evidence in *Haughton Graphic* painted a picture of much more extensive and open involvement of the defendants in daily business operations, with the defendants even representing themselves as officers of the limited partnership.

It is striking that neither Gibbs J.A. nor McEachern C.J.B.C. referred explicitly to any of these potentially distinguishing factors, preferring instead to rest their decisions on abstract principles pertaining to the integrity of the corporate structure. The judges did not comment on the trial judge's finding that the defendants had "clearly" taken part in "management". Indeed, there is no consideration of the defendants' conduct. In a subsequent case, the Court of Appeal may well reconsider the implications of *Nordile* and limit the case to its particular facts — notably the concession by Nordile that the defendants acted solely in their corporate capacities. In the meantime, however, investors and creditors are left uncertain as to the law on this point.

(2) Section 64 Excluded by Contract

The Court of Appeal also affirmed, with little discussion, the

³⁴ *Ibid.*, at p. 127.

³⁵ Statement of agreed facts, paras. 4 and 8; Statement of Defence, para. 5.

trial judge's decision that any liability on the part of the defendants under s. 64 was "excluded" by virtue of recital F in the agreement. The disclosure statement received no mention. It is surprising the court accepted this argument so readily, particularly since its first conclusion — that the defendants had acted only in their capacities as corporate managers — was sufficient to decide the case. It is even more surprising in light of the very brief and general nature of recital F. Although it describes the basic legal structure of a limited partnership, recital F does not refer expressly to s. 64. Indeed, it does not convey any express intention to exclude any aspect of the legislative regime. Moreover, it appears that Breckenridge and Rebiffe were never personally identified as limited partners, either in the agreement or in the disclosure statement. Certainly they were not made party to the agreement in their personal capacities.

Interestingly, the Court of Appeal also expressly approved the trial judge's decision to reject the specific reliance defence, even though this was unnecessary to dispose of the appeal. Like the trial judge, the court saw no contradiction in denying the relevance of creditor reliance while at the same time enforcing a loosely worded exclusion clause against the creditor.

It seems unlikely, given his strong language in *Haughton Graphic*, that Eberle J. would have recognized such a delicate distinction. After rejecting the defendants' testimony that they had scrupulously explained their limited liability status in all dealings with Haughton Graphic Ltd., Eberle J. went on to add the following:³⁶

I do not think the outcome would be any different if, contrary to my findings, [the defendant] had explained fully to [the plaintiff's agent] the legal particulars of the limited partnership, the legal relationship of the persons and entities concerned, the precise nature of the liability of each of them, and to whom the liabilities were owed. I say this because under s. 63 of the Alberta Act it is clear that the legal relationships can be altered by activity on the part of the limited partner.

Eberle J. did acknowledge that in some "unusual situation . . . it might be argued that the creditor had in some way estopped himself from relying on s. 63".³⁷ It is highly improbable, however, that he would consider such an estoppel to arise from the brief generalities set out in recital F of the Nordile/Arman agreement.

³⁶ *Haughton Graphic*, *supra*, footnote 3, at p. 133.

³⁷ *Ibid.*

III. THE POWER OF JUDICIAL VALUES

It will be apparent by now that I consider the decision in *Nordile* to be unfair and prejudicial to those members of the public who deal with limited partnerships. Still, it must be acknowledged that s. 64 of the Partnership Act does not clearly require a different result — it simply leaves open these kinds of questions. Fundamentally, the divergence between *Nordile* and *Haughton Graphic* illustrates how judicial values and attitudes impact on statutory construction.

The limited-partnership form is characterized by a profound tension between the traditional model of partnership, in which creditors may hold partners fully responsible for the firm's debts, and the modern corporate concept of virtually absolute limited liability. Within this legislative framework, it is perfectly possible to incline either towards the enforcement of personal liability, as in *Haughton Graphic*, or to defend the integrity of the corporate veil, as in *Nordile*. A major determining factor, I would argue, is the moral and political attitude of the presiding judge towards limited liability.

If limited liability is conceived of as a privilege granted by the state under certain conditions to further a broad public interest, a failure to comply with those conditions must result in the loss of that privilege. Within this paradigm the court's role is to protect the public interest against attempts by individual investors to obtain the benefits of limited liability without its responsibilities and burdens. This conception informed the judgment of Eberle J. in *Haughton Graphic*. The statutory protection from personal liability was strictly conditional, in his eyes, on the limited partners remaining passive. Participating in the control of the business *in any capacity* was "patently prohibited by the legislation" and would necessarily result in a loss of limited liability.³⁸ Eberle J.'s decision displays a clear lack of tolerance for private investors who try to "take advantage"³⁹ of limited liability while avoiding its constraints.

The decision in *Nordile* is founded upon a very different set of assumptions, namely that private capital owners are entitled to carry on business with limited liability as a matter of right, and

³⁸ *Ibid.*, quoting Flannigan, *supra*, footnote 24.

³⁹ *Supra*, text at footnote 33.

courts are justified in interfering with that right only in the most compelling cases of unfairness or deceit. From this perspective, private arrangements are deemed effective so long as they satisfy formal legal requirements, regardless of broader regulatory objectives. Underlying this approach is a normative stance which takes individual liberty and freedom of contract as its point of departure and equates these values with the public interest.

Thus, in *Nordile* the judges' primary concern was whether the formal legal relations between the individual parties were effective to shield the defendants from personal liability. They gave little attention to issues of legislative policy and the possible interests of wider society. Indeed, the judges' concerns about corporate limited liability largely overshadowed any discussion of the limited-partnership form or its legislative framework. McEachern C.J.B.C.'s warning about the need to protect the "Salomon principle" sits in sharp contrast to Eberle J.'s disapproval of those who would take advantage of the limited-partnership vehicle without bearing its burdens.

Moreover, both the trial and appeal judges in *Nordile* gave the disclosure clause in the agreement its maximum breadth. Without any discussion of the legislative policies which might lie behind s. 64, they held that it was effectively excluded by the agreement, despite the lack of any express reference to the section or any stated intention to contract out of the legislative scheme. The judges were undeterred by the fact that their decision could render s. 64 meaningless for anyone astute enough to put the necessary corporate structure and contractual terms in place.

Obviously, the relative power of these competing value systems may shift with the context. It would be interesting to know, for example, how the B.C. courts would have decided *Nordile* had the plaintiff been an individual consumer rather than a corporate real estate developer. The case might be even harder if it involved a claim for personal injury damages rather than a contract debt. In such circumstances, a judge may think differently about private ordering and the importance of legislative policy. In all cases, however, the application of s. 64 will turn largely upon the normative perspective of the court.

IV. LIMITED PARTNERSHIPS AND THE TAX SYSTEM: GIVE ME SHELTER!

I have suggested that the difference between *Haughton Graphic* and *Nordile* lies fundamentally in judicial values. Legal analysts are therefore sure to disagree about which decision is better. However, those who prefer the approach taken in *Nordile* must also be prepared, in my view, to reopen the question of limited-partnership taxation.

Lurking in the background of both these cases are the income tax benefits associated with limited-partnership investments. Although income tax issues were not raised directly in either case, the legal structures put in place by the defendants in *Haughton Graphic* and *Nordile* were almost certainly motivated by a desire to claim deductions available to limited partners under the Income Tax Act.⁴⁰

As a vehicle for carrying on business, the limited partnership generally does not offer the same degree of organizational flexibility or guarantee of limited liability as does the corporate form. Rather, the primary reason for investing in a limited partnership is tax-related. A recent investment advice column summed up the modern-day purpose of limited partnerships nicely: "they are meant to provide a small return, a tax shelter and some portfolio diversification for high income individuals".⁴¹

A brief explanation is in order for those unfamiliar with the mechanics of tax shelters. Unlike a corporation, a partnership does not comprise a separate legal entity from its members. Limited partners are therefore considered to hold a direct interest in partnership assets even though they enjoy a degree of limited liability similar in most respects to that of corporate shareholders. As a result, limited partners may deduct their proportionate share of any business losses incurred by the partnership in computing their incomes for tax purposes.⁴²

These deductions in effect "shelter" or reduce the partner's

⁴⁰ S.C. 1970-71-72, c. 63, as amended (the "ITA").

⁴¹ "How to invest in the oilpatch — and get a tax break in the deal", *Financial Times*, July 6, 1992. See also McQuillan, Thomas and Cochrane, *Understanding the Taxation of Partnerships*, 2nd ed. (Don Mills, CCH Canadian Ltd., 1987), para. 410, where the authors confirm the tax shelter purpose underlying the popularity of limited partnerships, and note that once the limited partners' ability to deduct losses is exhausted, the partnership is frequently rolled over into a corporation.

⁴² See ITA, s. 96(1); and McQuillan, *ibid.*, at para. 204 and chapter 2 generally.

income from other sources. This is especially advantageous if the business losses do not result from out-of-pocket expenses, but rather from accelerated rates of depreciation permitted under the ITA.⁴³ Moreover, current losses may be recoverable at a later time if partnership property can be sold for a capital gain, which is taxed at a lower rate than ordinary business income and may even be tax exempt.⁴⁴

Shareholders are not entitled to the same flow-through of expenses incurred by their corporations. Since the corporation is a separate person in law, profits and losses belong to the company itself.⁴⁵ Shareholders ordinarily are not taxed on corporate income until it is paid out to them in the form of dividends, and similarly they may not deduct corporate losses.⁴⁶

The separate personality of the corporation is also the basis for the shareholder's limited liability. The shareholder may be appointed as a director, senior officer or employee, and as such may manage the company business without risking liability for the corporation's debts. The effect of *Nordile*, however, is to extend virtually the same insulation from liability to limited partners. Indeed, McEachern C.J.B.C. in his concurring judgment appealed directly to the principle of separate corporate personality in holding that the defendants had successfully avoided personal liability under s. 64. The case largely blurs the distinction between limited partners and corporate shareholders for all purposes except income tax, making it increasingly difficult to justify the flow-through of tax losses to limited partners.

⁴³ It should be noted that the amount of losses from a business or property and the amount of investment tax credits which can be claimed by a limited partner are restricted to her "at-risk amount" in respect of the partnership at the end of its fiscal period. The "at-risk" rules were introduced to prevent limited partners from obtaining tax shelter benefits which exceed the value of their actual investment in the limited partnership: see ITA, ss. 96(2.1) to (2.7), ss. 127(8.1) to (8.5). See also McQuillan, *ibid.*, at paras. 415 to 465.

⁴⁴ The ITA requires only 3/4 of a capital gain to be included in income as a "taxable capital gain": see ss. 3(b), 38. Taxable capital gains realized on the sale of partnership property are allocated to the partners, who are eligible for the lifetime capital gains exemption for up to \$75,000 in respect of such amounts, provided they satisfy the conditions of s. 110.6. Section 110.6(11) is an anti-avoidance provision which aims in part to prevent a partner from claiming the exemption for a share of taxable capital gains of the partnership which exceeds her proportionate share of partnership income.

⁴⁵ Under the ITA, a corporation is a "person" and a taxpayer in its own right: ss. 2(1), 248(1).

⁴⁶ Individual shareholders must include in their income any dividends received from the corporation: see ITA, ss. 82(1), 90(1). For shareholders of corporations resident in Canada, the tax burden in respect of such dividends may be reduced by the dividend tax credit mechanism: see ITA, ss. 82(1)(b), 121.

The case for allowing limited partners to deduct partnership losses was tenuous from the outset. These investors do not assume the same risks as general partners or sole proprietors and, as indicated earlier, they invest mostly to shelter other income from taxation. This is one of the most obvious examples of market distortion in the income tax system, altering as it does the choices investors would otherwise make in the absence of a tax incentive. More importantly, it is a severely inequitable tax preference — it reduces the effective tax rate on individuals with very high incomes, undermining the redistributive potential of our progressive rate schedule.⁴⁷

There may be good reasons for supporting industries which historically have raised capital through limited-partnership financing. However, this support should be directed to the particular types of economic activity we wish to promote or protect. Under the current system, the subsidy is extended to anyone who employs a particular form of investment structure, regardless of the nature of production undertaken. This approach assumes that public support is equally warranted for such diverse enterprises as film making, natural resource exploration and, as *Nordile* illustrates, the commercial real estate industry.

In addition, there are serious problems associated with using the tax system to deliver these subsidies to industry. There is no upper limit on the amount of revenue which may be lost through the sheltering of limited-partner income. It would be preferable to determine the levels of support which are fair and efficient and to establish a specific fund for that purpose. Direct subsidies also tend to be more visible and allow for greater political accountability and cost-benefit review.⁴⁸

The Department of Finance reported recently that the deduction of limited partnership losses had a cost in terms of revenue forgone of \$125 million in 1988 and \$170 million in 1989.⁴⁹

⁴⁷ In 1989, 64% of all deductions in respect of losses incurred by limited partners or non-active partners were claimed by tax filers with incomes of \$50,000 or greater (comprising 8.3% of all returns filed). Persons with incomes of \$100,000 and over (1.2% of tax filers) claimed 43% of the total. These figures were calculated from Revenue Canada, Taxation, *1991 Taxation Statistics* (Ottawa, 1991), Table 15, at p. 302. They are conservative estimates, because the income brackets are based on income for tax purposes, after deducting limited-partnership losses (*ibid.*, at p. 27).

⁴⁸ For a review of the possible advantages and disadvantages of delivering government assistance through direct spending programs versus tax expenditures, see Stanley S. Surrey and Paul R. McDaniel, *Tax Expenditures* (Harvard University Press, 1985), pp. 99-108.

⁴⁹ Canada, Department of Finance, *Government of Canada Personal Income Tax Expenditures* (December 1992), p. 12.

Although the amount of this revenue loss is itself notable, the more important question is whether this tax expenditure produces any return to the economy in terms of employment, profits and other indicators. One recent study indicates that the transfer of tax losses to limited partners via the flow-through system is a highly inefficient way to deliver support to industry, because of the transactional costs involved in forming limited partnerships and the premiums demanded by investors to compensate for financial risk. The author of the study concludes that these tax incentives "have the potential to waste large amounts of tax revenue", and may produce "a level of hidden costs that is unlikely to be tolerated in a system of open subsidization".⁵⁰ It is difficult to argue that direct subsidies would represent any greater government "interference" in the market than that found in the current system, in which investors are encouraged to place their capital with unprofitable enterprises.

There are undoubtedly legitimate organizational reasons for choosing the limited-partnership structure, and no obvious reason to remove this option from the forms of business organization available in Canada. However, the fact that limited partners own an undivided interest in partnership property for the general purposes of the law does not necessitate parallel treatment for income tax purposes. Governments wringing their hands over budget deficits should be eager to eliminate unproductive and unfair tax preferences. The *Nordile* decision reinforces the case for curtailing the tax shelter benefits presently available to limited partners and establishing a system which treats them more like corporate shareholders for tax purposes.

⁵⁰ Glenn P. Jenkins, "Tax Shelter Finance: How Efficient Is It?" (1990), 38 *Canadian Tax J.* 270, at p. 280.